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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

International Finance Series No. 27

The Revolt Against The Dollar

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CENTRAL INTELLIGENCE AGENCY

Directorate of Intelligence

July 1971

INTELLIGENCE MEMORANDUM

THE REVOLT AGAINST THE DOLLAR

SUMMARY AND CONCLUSIONS

1. On 5 May 1971 the West German central bank (the Bundesbank) withdrew from support operations in the foreign exchange market, ending a frenetic conversion of dollars into Deutschemarks (D-marks) that had increased Bundesbank dollar holdings by about $1 billion in less than an hour of trading that Wednesday morning. Fearing a greatly expanded inflow of dollars into their reserves once the Germans had acted, the central banks of the Netherlands, Belgium, Switzerland, and Austria quickly followed the Bundesbank's example. On the following Monday, the West German foreign exchange market resumed trading, with the D-mark temporarily "floating" (that is, selling at a freely-determined market price rather than at a rate kept within prescribed, narrow bounds around parity by central bank intervention in the market). The D-mark soon was selling for dollars at about 3% above the nominal parity, and the volume of transactions was relatively small. The Dutch guilder was also floating and selling above its nominal peg; the Belgian franc was floating with respect to capital transactions; the Swiss franc and Austrian schilling had been revalued.*

2. The immediate chain of events leading to this latest international monetary problem is clear enough. Last year the United States shifted to an expansionary monetary policy to help get the US economy out of its recession at a time when tight money policies to combat inflation still prevailed in Western Europe. US interest rates were reduced sharply, but European interest rates were lowered only slowly and reluctantly. By early 1971, money was earning as much as three to four percentage points more in Europe than here. With exchange rates allowed to fluctuate less than 1% on either side of parity, investing funds in Europe offered enormous profits at low exchange risk. Placement of funds in West

*Throughout this memorandum, the term "revaluation" is used to mean an upward adjustment in the exchange value of a currency, as opposed to a "devaluation."

NOTE: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

Germany accounted for a lion's share of the movement of short-term funds, not only because interest rates there were among the highest then obtainable but also because a consistently favorable balance of payments and the unusually strong traditional antipathy to inflation in that country made the D-mark Europe's strongest currency. As the massive capital flow continued, more and more people began to anticipate that the D-mark and certain other strong currencies would be revalued, and a full-blown speculative conversion of dollars into D-marks, guilders, and Swiss francs ensued.*

3. The foreign exchange crisis of May 1971 was, in an immediate sense, a crisis of the D-mark. It was brought on by the avalanche of speculative funds into West Germany, and its "unwinding" is following a course set by the German decision to float the D-mark. The direct economic effects of this crisis have thus far been small. Some speculators lost money, travellers suffered inconvenience, and some disruption of commercial arrangements occurred; but there has been no noticeable impact on overall economic activity.

4. The events of May also were the culmination of increasing European concern and dissatisfaction over the role of the dollar as an international reserve currency—and over the failure of the United States to pursue policies which, in the European view, would support that role. In today's world, however, the pace of economic activity is frequently out of phase among various countries. The mix of monetary and fiscal policies employed in these countries influences to an important degree the impact of international monetary flows on their domestic economies. No country has found a satisfactory policy mix to reconcile its domestic and foreign economic objectives. For internal reasons, the European countries have generally relied heavily on monetary policy, and this indirectly contributed to dollar inflows.

5. In a broader sense, the West German determination to float the D-mark signalled an end to the almost automatic acceptance of US leadership and US solutions that had characterized monetary crisis management in the postwar period. It was a revolt against the dollar: not a revolution, but a symbolic revolt—a sort of monetary Boston Tea Party. Although at odds in their attempts to shape a common course of action, the European Community (EC) countries are joined in dismay at large, continuing US balance-of-payments deficits and generally support West German determination to be less closely tied to the United States in matters of international monetary policy. The EC countries, moreover, are clearly inclined to seek solutions that will insulate their economies from outside disturbances. Although they differ with respect to the most appropriate solutions, the EC countries are in substantial agreement concerning the identity of the underlying causes of the current crisis.

6. The most fundamental issue is the present system of fixed exchange rates. The postwar international monetary system created at Bretton Woods provides for the correction of a fundamental balance-of-payment disequilibrium through changing the exchange rate parity. Such changes, however, have occurred only infrequently among the advanced industrial countries, and the parity adjustments have been relatively small. The reluctance to effect parity changes in the face of serious basic payments imbalances has at times led to prolonged and costly support operations that together with deflationary domestic measures

*The flight to the D-mark was not solely from dollars; but, because the dollar is the intervention currency, it was dollars that flowed into Germany.

stifle growth. Desperately short of reserves and with large external sterling obligations, the United Kingdom for many years followed "stop-go" policies which postponed devaluation, possibly at a high cost in terms of economic growth.

7. In the past few years, the regime of fixed exchange rates has contributed to the serious and largely new problem of disturbances created by massive international flows of short-term capital. With the transfer of funds relatively free from restriction, with increasingly efficient money markets, and with risk of exchange loss minimized by the fixed exchange rate system, movement of short-term capital from one country to another on the basis of interest rate differentials became more profitable than ever. Given the lack of synchronization in economic activity among the major countries, as well as the independence of their economic policies, interest rate differentials are inevitable. Moreover, reliance on manipulation of interest rates to attain domestic economic policy goals may mean that even large short-term capital flows will not lead to rapid narrowing of interest rate differentials between countries. Hence interest-motivated transfers of funds may continue to a point where speculative interest in a parity change is kindled.

8. An issue closely related to that of fixed parities is the international role of the dollar. European reaction to the dollar as a reserve currency supplying an important part of international liquidity evinces a sort of love-hate relationship: the dollar is widely accepted as a desirable financing medium, but there is a general belief that far too many dollars have been pumped into private and central bank coffers as a result of US deficits. The decrease in the US gold stock, the rapid increase in US dollar liabilities to foreigners, and the continuation—even in a period of US recession—of large balance-of-payments deficits have contributed to a growing feeling that the dollar is not as "sound" as it used to be. Furthermore, the dollar in one way or another represents a US influence that has aroused strong resentment in some quarters. Many Europeans view US deficits as having forced them, in effect, to pay for US acquisition of plants in Europe, for part of the US share of NATO defense costs, or for the Vietnam war. And, increasingly, there has been a feeling of frustration over dollar flows that have diluted European control of domestic economic policies.

9. In 1970-71 the fixed exchange rate problem and the dollar problem converged alarmingly. Massive short-term capital flows from the United States to Europe impeded European central banks' efforts to fight inflation. Already resentful of the seemingly endless and intractable US deficits, the Europeans saw in the capital inflow and in the consequent expansion of their money supplies an unacceptable further limitation on their freedom of action resulting from policies determined by US domestic considerations. These considerations have produced a new consensus among the EC countries that the international monetary system or the international role of the dollar—or both—would have to be changed. The fact that an important part of European holdings of dollars was created by the credit operations of European banks (including the central banks, particularly in 1970) in the so-called "Eurodollar" market has not significantly diverted criticism from the United States. Recognition of the extent of the Eurodollar problem, however, has underlined the need for European action to bring about changes in the ground rules of international finance, particularly with respect to short-term capital flows. There is wide disagreement, however, on

what action to take: the German Government seeks more flexibility in exchange rates, while the French advocate stringent controls over international capital flows with fixed exchange rates being preserved.

10. An additional complication is the effect of the crisis on progress toward economic and monetary union in the EC. The basic problems here are European and political. Last February, as the result of a compromise between the French and German positions, a decision was taken to back into monetary union—to take the first steps in narrowing the bands within which EC currencies can fluctuate with respect to each other while leaving until later the major moves in policy coordination necessary to synchronize the member countries' economies. Narrowing the bands, originally scheduled for 15 June, has been postponed because of the German insistence of floating the mark.

11. The mechanics of many Community activities, especially the Common Agricultural Policy (CAP), are based on fixed foreign exchange parities. The Community has adjusted to past changes in parities by resort to temporary measures to ease adjustment in the countries affected. In the present crisis, more difficulty has been encountered in arriving at Community solutions, although the cracks in EC unity have been papered over. This crisis has shown the member countries—France and West Germany in particular—to be quite far apart in their approach to coordinating economic policies that affect vital national interests, yet still determined to preserve at least the forms of common action in the Community.

12. The events of May can be expected to provide a qualitatively different result from those of previous postwar international monetary crises. The emphasis among the European countries today is not on patching up existing international monetary relationships but on attaining autonomy over domestic economic policies which presently are hampered by the widespread use of the dollar as an international reserve and transaction currency. Emerging from a long period in which US leadership in management of international monetary affairs was unchallenged, the Europeans are intent on formulating their own decisions. As a short-run expedient to insulate their economies from disturbances originating in international monetary flows, they are resorting to measures that contravene the letter and spirit of present international monetary rules; in the long run, they will work within the EC itself, in the Group of Ten, and in the International Monetary Fund (IMF) to introduce changes in the rules. Many of the old ties will remain, but US influence probably will diminish as the US role, essentially a dominant one in the postwar period, changes to one of *primus inter pares*.

13. If the EC countries can bridge the differences in their approaches, a strong European initiative to hasten change in the rules of the international monetary system might come as early as the annual meeting of the IMF in September; however, little can be foreseen with respect to the specific nature of the changes that may be sought. The Europeans share in the worldwide division of opinion as to the sort of revisions that would make the system more compatible not only with national and international economic goals but also as to just what some of those goals should be. For example, free international movement of goods and capital has been generally accepted as an article of faith among the industrialized countries of the Free World in the postwar period. The recent foreign exchange crisis, however, has starkly demonstrated the greatly increased disruptive potential of short-term capital flows that is in part due to the devel-

opment of more efficient international money market mechanisms, notably the Eurodollar market. Whether revisions of the rules will embrace one or another proposal cannot be predicted. A variety of schemes have been advanced, ranging from a substantial overhaul of the fixed exchange rate system (by widening the "bands" or adopting "crawling pegs") to an approach involving some variant of a two-tier system providing fixed rates for trade and other current transactions and floating rates for capital movements. Moreover, there is considerable scope for different policy "mixes" in the IMF (affecting international monetary relations worldwide) and in the EC (affecting specifically the relations among member countries). At present there are deep divisions among the EC countries and, internally—between government officials responsible for economic policy on the one hand and central bank officials on the other hand—with respect to the most desirable course of action. There is a consensus, however, that the search must continue for a means of preventing the Eurodollar market from again making a massive contribution to disequilibrating short-term capital flows.

14. Longer-term effects on EC unity are obscure. A large measure of agreement exists among the member countries on the need to carry through the revolt against the dollar by setting constraints on the international role of the dollar as a reserve currency and as the pivot of the fixed exchange rate system. The impact of international monetary disturbances on their domestic economies would probably provide sufficient cause for such determination. But the matter has political overtones: a growing awareness of European economic strength and a crystallization of longstanding resentments of US dominance and the growth of US influence in European economic affairs also are factors. The West German and French Governments, however, remain at loggerheads over the question of relying on market forces or resorting to direct controls to fetter unwanted capital flows. Some hard but needed lessons have been learned from this crisis regarding the fundamental relation between exchange rates, short-term capital flows, and the international synchronization of economic activity. It is possible that this experience may eventually lead the EC to agree on implementing the higher degree of economic policy coordination that is a technical and economic necessity for success in significantly narrowing of the bands among Community currencies and moving on to meaningful monetary union.

DISCUSSION

PROXIMATE BACKGROUND OF THE CRISIS

Interest-Motivated Dollar Inflow

15. From the beginning of 1970 into early 1971, short-term interest rates in the United States fell sharply as monetary policy eased to stimulate recovery. In West Germany, however, the Bundesbank was striving to keep a tight rein on monetary expansion and short-term interest rates on three-month interbank deposits were over 9% through most of 1970. As a result, US and West German short-term interest rates diverged sharply in 1970 and reached a spread of 3.5 percentage points at the end of the first quarter of 1971 (see Figure 1). The Eurodollar rate fluctuated about one-half percentage point above the US rate in 1970 then rose sharply in the first quarter of 1971. In markets where a differential of about 0.2 percentage points between US and Eurodollar rates, and about 1 to 2 percentage points between US rates and those in another currency, can produce significant flows of short-term funds, the increases in differentials during 1970-71 provided a powerful stimulus to the transfer of funds into strong European currencies—particulary into the D-mark. Smaller amounts (although large in relation to the size of the Dutch and Swiss money markets) flowed into the Netherlands and Switzerland. As shown in Figure 1, a rapid rise in Swiss interest rates markedly narrowed the negative differential from US rates and thus enhanced the traditional attractiveness of the Swiss franc as a safe haven from a variety of money market risks.

16. Spurred by the greatly increased spread between US and European interest rates in late 1970, a massive amount of short-term capital flowed into Western Europe—in particular, into West Germany. Some of these funds became dollar assets held by European commercial banks. But much larger amounts were converted into national currencies, a process that resulted in a rapid rise in the European central banks' holdings of dollars.

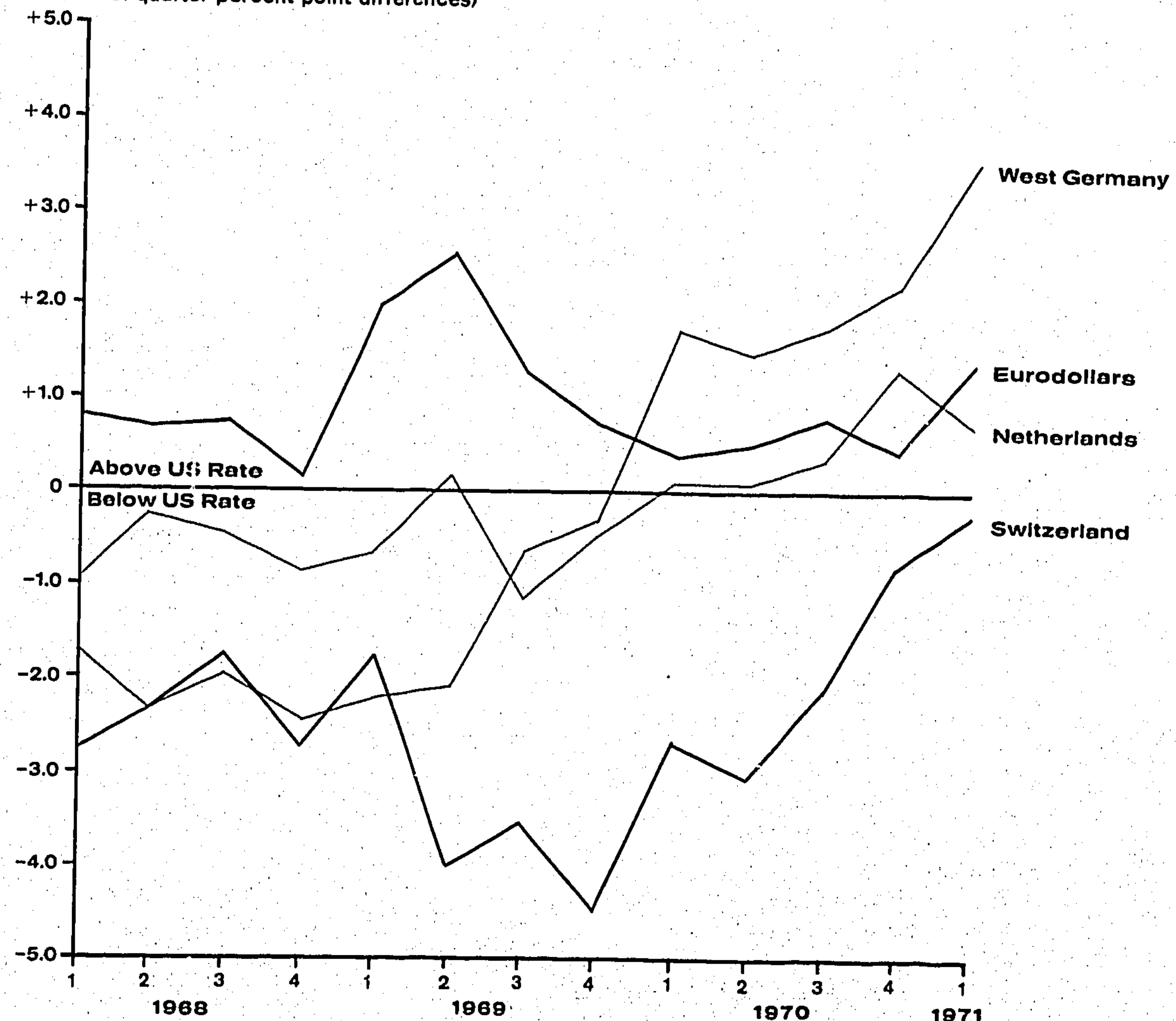
17. The inflow of dollars increased the official holdings of foreign exchange by the EC countries, Switzerland, Austria, and the United Kingdom from some $8.5 billion at the end of 1969 to $17.5 billion at the end of 1970. The increases in the foreign exchange reserves of these Western European countries (along with Japan) during the past three years are shown in the top panel of Figure 2.* The most notable accumulation occurred in West Germany, where the central bank's foreign exchange holdings expanded by nearly $8 billion in the fifteen-month period to the end of March 1971. By the end of 1970, this accretion of dollars had increased the proportion of foreign exchange in West Germany's total external reserves to 62%, compared with 38% a year earlier (see lower panel, Figure 2). In the first four months of 1971, an additional inflow of

*Note the logarithmic vertical scale; for example, the 1970 increase shown for West Germany is nearly $6 billion while that for France is $1 billion.

Short-Term Interest Rate Differentials Between the United States and Selected Financial Markets

Figure 1

(End of quarter percent point differences)



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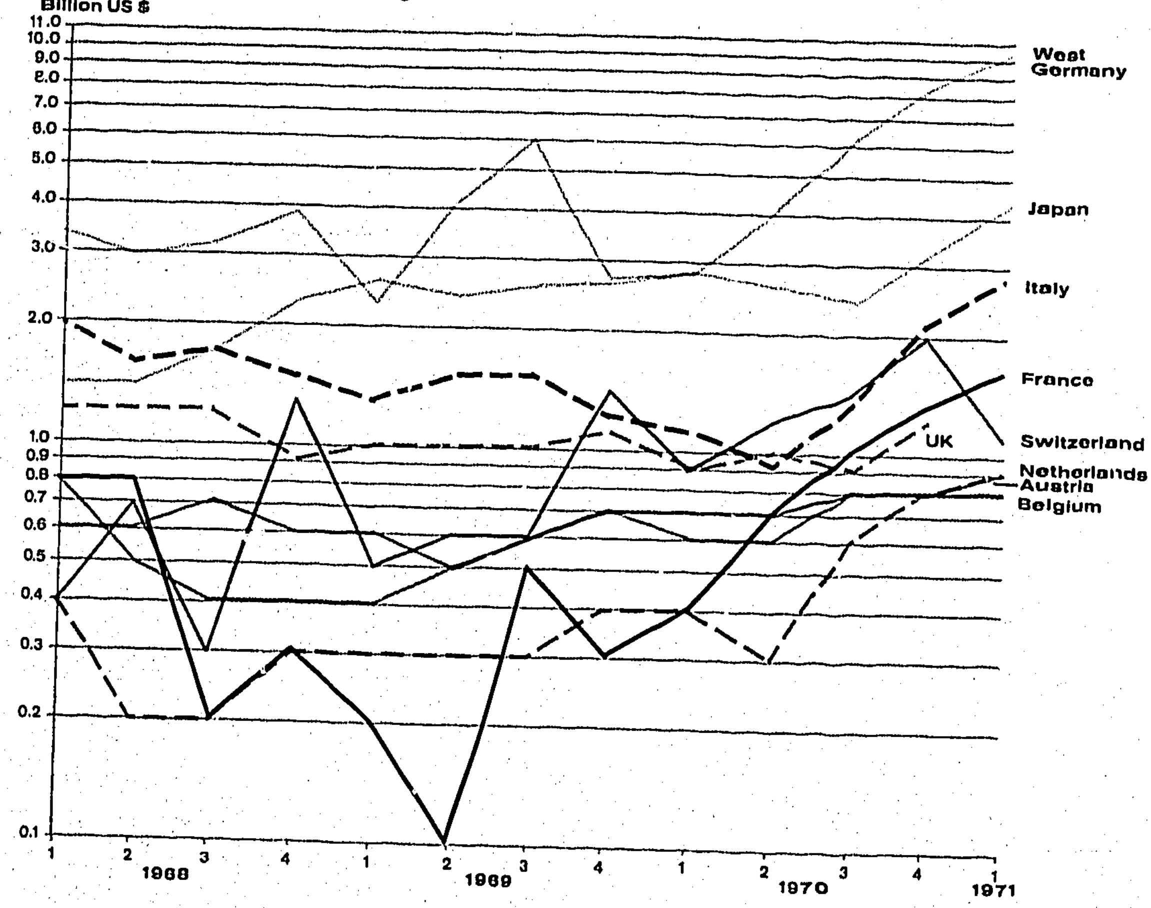
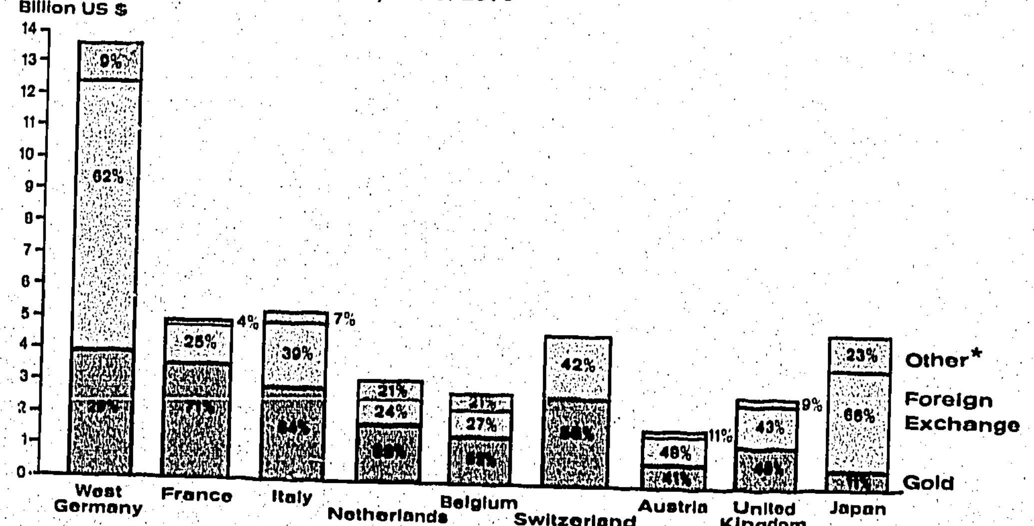
International Liquidity

Figure 2

Official Holdings of Foreign Exchange



Size and Composition of Reserves, End of 1970



*Special drawing rights and reserve position in the IMF

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$2.9 billion raised the proportion to 68%. Moreover, adding to the concern of German officials, the Bundesbank was paying for the dollars it acquired with D-marks, thus increasing commercial banks' reserves and making possible expansion of the domestic money supply. Ironically this was a result of the large US-West German interest differential which, in turn, was partly due to the Bundesbank's high-interest policy—a policy designed to hold down expansion of the domestic money supply.

18. The dollars that flooded into Western European central banks originated in a variety of short-term capital transactions, some involving direct transfer of funds from the United States, and some resulting from conversion of Eurodollars. The short-term capital account (including "errors and omissions") in the US balance of payments turned about dramatically, from a $5.7 billion net inflow in 1969 to an $8.4 billion net outflow in 1970. This was the main factor contributing to the record $10.7 billion deficit in the overall payments balance on official settlements basis—a deficit almost three times as large as the previous record deficit and a marked contrast to the $2.7 billion surplus realized in 1969. The bulk of the 1970 deficit was settled by a $7.6 billion increase of liabilities to foreign central banks.

ILLEGIB

19. The reported increase in Western European central banks' change reserves (nearly all in dollars) was, however, several billion greater than the increase in US liquid liabilities to these institutions. This difference is almost entirely accounted for by the European central banks' counting of Eurodollar holdings as part of their foreign exchange reserve position. However, Eurodollars are not claims against banks and others in the United States, but rather are dollar-denominated deposit liabilities of European commercial banks.* Eurodollars have their origin in the deposit of dollar claims against the United States in a European commercial bank. These claims, if held by the commercial bank rather than being sold to the central bank for national currency, can become the reserve or base for Eurodollar lending and a consequent increase in dollar deposit liabilities by the commercial bank. In a manner analogous to multiple expansion of demand deposits in a country having a fractional reserve banking system, Eurodollars can multiply—like rabbits, as Princeton's Professor Machlup suggests. Indeed, at the end of 1970, the volume of Eurodollars is estimated by BIS to have been $46 billion, an amount far in excess of the $20 billion or so in US liquid liabilities to commercial banks and other private holders in the Eurodollar area.

The Speculative Climax

20. It became increasingly evident that the West German authorities, faced with a 22.5% growth in the money supply in the twelve months ending in March 1971 and the swollen proportion of dollars in the country's external reserves, would soon be forced to act. A number of public statements by West German officials and economists gave strong impetus to speculation that the D-mark would soon appreciate as the result of a float. At the same time, reports were circulating that a significant amount of the "dollars" reported as reserves by

*Statistics published by Bank for International Settlements (BIS) are limited to banks in the United Kingdom, Switzerland, France, Germany, Italy, the Netherlands, Belgium, and Sweden.

the European central banks were in fact Eurodollars created by the European banking system itself. This news probably helped accelerate the rush of conversion into the stronger European currencies. Although this information should have told the Europeans that the dollar (defined as dollar claims against the United States) was stronger than had been believed on the basis of reported central bank holdings, the state of confusion concerning the distinctions between dollars and Eurodollars is such that many Europeans construed the reports as confirming allegations that there were too many dollars in Europe. The D-mark was in greatest demand at first, but the speculative fever soon spread to the Swiss franc and the Dutch guilder, both of which were also considered as likely candidates for revaluation.*

21. On Monday, 3 May, as the speculation mounted, five West German economic research institutes published reports advising that action be taken to stem the tide of dollars through operation of market forces—four institutes recommending a floating exchange rate and one, outright revaluation. Earlier German Economics Minister Schiller had entered the picture, making strong recommendations for exchange flexibility and increased reliance on market forces for corrective action at the meeting of EC finance ministers and central bank governors in Hamburg on 26 and 27 April. [redacted] 25X1

22. On 4 May, the statement of a high US official that the US balance-of-payments deficit, while important, could not be considered "at the top of the priorities list" and that the administration "does not intend to see our domestic economy sacrificed to international monetary objectives" was published in the press, and was taken by the Europeans as an official US acceptance of recent academic proposals for "benign neglect" toward the US external payments deficit. Although the US Treasury was offering to cooperate with European monetary authorities who might desire to fund some of their dollars in special Treasury securities, the stage was set for a full-blown speculative stampede into D-marks.

23. On 3 and 4 May, all these pressures combined to produce a flood of dollars into the Bundesbank totalling about $1 billion. Then, Wednesday morning, 5 May, speculators—looking upon revaluation of the Deutschemark as both inevitable and imminent—converted about $1 billion into marks in less than an hour of trading. The Economics Ministry ordered the closing of the foreign exchange market and the Bundesbank thereupon withdrew support for the dollar. It was

[redacted] 25X1

announced that the foreign exchange market would be closed until the following Monday, 10 May. Other strong currencies were also experiencing heavy trading, and the central banks of the Netherlands, Belgium, Switzerland, and Austria followed the German example and suspended trading. The Swiss alone had taken in some $600 million that day. The German action, of course, entailed costs to the country's commercial interests and an internal political-economic crisis in the EC, which only recently had decided to initiate the first step toward monetary union by narrowing of the "band" of Community exchange rates on 15 June.

UNDERLYING ISSUES

24. The particular combination of factors that precipitated the crisis is, of course, transitory. Certain elements in the situation may not recur; for example, to avoid feeding the Eurodollar expansion as they did in 1970, the European central banks already have agreed not to place new funds in the Eurodollar market. Moreover, the ebb and flow of economic activity in the major industrial countries sooner or later will lead to a changed pattern of interest rate differentials, and short-term capital may again flow back to the United States.

25. Two fundamental problems, however, persist. One of these is the operation of the fixed exchange rate system in a world of generally free movement of goods and capital. The second is the acceptability of the US dollar as an international reserve currency under conditions of continuing, large US basic balance-of-payments deficits. Because of increases in the scope and efficiency of international money markets in the past decade, short-term capital flows now are unprecedented in size and disruptive potential. Consequently, European government officials and central bankers are beginning to focus on the related problems of reforming the system, regulating specific market mechanisms (such as the Eurodollar market), and dealing with what in their view is an excessive supply of dollars.

The Fixity of Exchange Rates

26. The collapse of the international gold standard in the early 1930s and subsequent experience with competitive exchange devaluation left most monetary experts in opposition to both "permanently" fixed and freely fluctuating exchange rates. The most damaging aspect of a system of permanently fixed exchange rates is that maintenance of the rate under certain conditions may force a country to stifle economic growth and suffer domestic unemployment. A country having unemployment may simultaneously be experiencing inflation if institutional forces prevent downward adjustment of wages and costs. If its inflation is greater than that in other countries, balance-of-payments deficits will result. With fixed exchange rates, deflationary domestic monetary policies will be required, and these will lead to aggravation of the unemployment. On the other hand, in the years before World War II, the notion of freely fluctuating exchange rates not only was considered unthinkable by the business and financial community but also aroused fears among many economists of a resurgence of competitive exchange devaluation and an erosion of monetary discipline.

27. The International Monetary Fund Agreement, signed at Bretton Woods in 1944, attempted a fusion of desirable attributes of both exchange rate fixity and flexibility. The centerpiece of the system is a par value, or link between each

currency and gold (or the US dollar of the weight and fineness in effect on 1 July 1944*), that is to be altered only when necessary to correct a fundamental disequilibrium in the country's balance of payments. The monetary authorities in each country are expected to take action to keep the price of their currency from deviating in either direction from parity by more than 1%.** Transitory market pressures on an exchange rate can be dealt with by buying or selling the currency in the foreign exchange market—hence, the central banks' requirement for reserves of foreign exchange over and above transactions needs. Less tractable pressures on exchange rates, tending to make the price of a currency deviate from parity by more than the permitted amount, call for appropriate monetary or fiscal action to remove the pressures tending to push the rate beyond the "band."

28. To assist in the adjustment process, the IMF provides a supplementary source of financing temporary deficits of the member countries. The Bretton Woods agreement created a pool of resources—gold and foreign exchange—available for use on a short-term, revolving basis. Medium-term stabilization assistance is available to IMF members upon a showing that they are in balance-of-payments deficit and are taking appropriate measures to cure the deficit within a reasonable period of time.

29. The "fixed-except-when-changed" system of exchange parities is exposed on the flank to serious disequilibrating speculation in a world where effective international coordination of economic policies has not been attained. During the early postwar years, this structural weakness of the system was not critical, because of the prevalence of exchange controls. But with the achievement of convertibility of the major currencies and generally free movement of capital between countries, divergent growth trends and rates of inflation as well as divergent monetary policies, on occasion led to large flows of international reserves between countries. The size and persistence of these flows attracted the attention of speculators hoping to profit from possible change of parity. The ability of the speculators to mobilize massive amounts of liquid funds tends to force the anticipated change in parity. Thus, by postponing exchange-rate adjustments until they are large enough to be profitable for the speculators, the present system exposes the foreign exchange market and the domestic economies of the countries affected to sudden shocks. Although more gradual changes in exchange rates might prevent matters from reaching the speculative stage, the turmoil associated with past changes in exchange rates has led to general aversion to exchange-rate adjustments. Adjustments occur, but seemingly only when matters have progressed to the crisis stage. The result is a system that operates with exchange rates more rather than less permanently fixed—a negation of the Bretton Woods intent to build some flexibility into the system.

30. Discontent with the relatively inflexible operation of the international monetary system has grown markedly in recent years. In view of the chronic US balance-of-payments deficit and the shrinkage of US reserves, Europeans

*The US dollar has been defined as 15 5/21 grains of gold nine-tenths fine since 1934.

**In practice, the intervention points of many of the major European countries have been about 0.75% above or below parity; for West Germany (before the float), about 0.82%; for the United Kingdom, 0.83%; and for Switzerland, about 1.6%. The Swiss central bank, however, is maintaining a narrower band *de facto*.

have for some time questioned the central role of the dollar in the system. A more recent and alarming concern is the huge volume of short-term funds that stampede from one country to another in response to interest rate differentials and speculative drive. These flows, as illustrated by the present situation, can have profound effects on an economy. For example, heavy inflows of dollars can negate a country's attempts to control inflation and, when adjustments are finally made through revaluation or restrictive domestic measures, adverse effects on employment may result.

31. A large number of proposals for reform of the international monetary system have been advanced since the Bretton Woods system was created. They range from minor extension of the existing system by the adoption of additional key currencies all the way to scrapping the adjustable-parity system and instituting freely fluctuating exchange rates. A great deal of interest has centered on proposals to widen the bands within which exchange rates are permitted to fluctuate without triggering central bank intervention. A "crawling peg" that would allow small changes of parity frequently enough to bring about adjustments in a country's international accounts before imbalances become troublesome has also been discussed, largely in academic circles. In the wake of the 5 May crisis, considerable attention has been given the two-tier Belgian system. This system retains a fixed official rate of exchange for trade and other current transactions but channels capital transactions through a free exchange market. All these proposals would place more of the task of adjustment on alterations in exchange rates and thus lift some of the burden of adjustment from domestic policies affecting growth, employment, and prices. Proponents also believe that these schemes would tend to discourage speculation by increasing the attendant exchange risk.

The International Role of the Dollar

32. The supply of monetary gold and dollars from the United States has been a major source of increase in the reserves of other countries' official reserves in the postwar period. In 1949 the monetary gold stock of the United States was nearly $25 billion—more than two-thirds of the world total. Since then, however, some $14 billion of this gold has been transferred to other countries, and, in addition, US liquid liabilities to foreign official institutions have risen by a little under $20 billion. US reserves and US liquid liabilities thus have supplied nearly two-thirds of the $53 billion rise in the total international reserves of other Free World countries from 1949 to the present. Without this added liquidity, other countries would have had to resort to parity changes more frequently or, more likely, would have had to retain much tighter controls on trade and payments.

33. In the 1960s, foreign central banks became increasingly reluctant to further increase their dollar holdings. The rapid growth of the European economies put the United States in a far less dominant economic position. At the same time, the growing financial strength of the European countries increased their freedom of action in economic policy. In many quarters, large dollar inflows were no longer viewed as a welcome source of liquidity. Rather they were considered to be a kind of forced loan by means of which the United

States financed international activities many Europeans did not favor (for example, purchase of European firms by US interests and, later, prosecution of the Vietnam war).

34. Added to reactions that basically reflect a growing European sense of strength and identity in economic and financial affairs are increasing concerns about the soundness of the dollar as an international reserve asset. The US economy is still by far the largest and most developed in the world; moreover, the purchasing power of the dollar is less subject to external influences than that of any other major currency. A currency's soundness, however, is in large measure a subjective matter to the holder, and in some quarters still is closely identified with the size of the issuing country's gold stock. The divergent trends of the US monetary gold stock and US liquid liabilities to foreigners, shown in the tabulation below, has been unsettling to those who view the ultimate worth of a currency largely in terms of its "cover."*

	Billion US$		
	US Monetary Gold (Including Exchange Stabilization Fund)	US Liquid Liabilities to Foreigners	
End of Period		Total	To Official Institutions
Dec 1958	20.6	16.8	8.7*
Dec 1960	17.8	21.0	11.1
Dec 1965	13.8	29.1	15.4
Dec 1970	11.1	43.3	20.1
Apr 1971	10.9	44.1	22.3

* Short-term liabilities reported by banks in the United States.

35. In addition to gold, US reserves include roughly $3 billion in Special Drawing Rights (SDRs) and reserve position in the IMF. There are several billion dollars in short-term claims against foreigners, but these are largely tied to current financing of commercial transactions. In a broader sense, the dollar is backed by a huge volume of net US long-term claims against foreigners—some $55 billion in 1969. Such long-term claims, however, provide little help in meeting pressing demands for conversion. The history of the pound sterling during World War II and during the postwar balance-of-payments crises attests to the liquidity problem that can result from having one's assets predominantly in long-term claims while the liabilities are predominantly short-term.

36. This situation also presents a dilemma to the foreign central banks holding dollar claims against the United States. Many of these dollars are held to provide reserves in the form of earning assets rather than in sterile gold. Traditional notions of balance among reserve assets, however, would have dictated substantial conversions of dollars into gold as dollars flooded into the European central banks at an accelerated pace in the past year. But at the end of 1970, US liquid liabilities to the West European central banks stood at some $13 billion and an additional $7 billion was outstanding to central

*It should be noted that the decline in the gold cover for US liquid liabilities may not be as great as implied by these data. Before 1968, part of the US gold stock was tied up as a statutory reserve against domestic currency, so that—technically—the amount available to satisfy foreign claims was quite small. But it was generally understood that the United States would honor external official claims against its gold stock. Removal of the statutory domestic gold certificate reserve requirement against Federal Reserve Bank note and deposit liabilities was completed in 1968.

banks in other parts of the world. With the holdings of West European official institutions exceeding the total size of the US gold stock, it was evident that any substantial presentation of dollars for conversion would drastically deplete US reserves, that such an attempt would force the United States to embargo gold sales, and that the foreign central banks were effectively "locked in."

37. The massive inflow of short-term capital, expanding already swollen foreign exchange reserves with dollars that in fact could not be converted into gold, came on top of basic longstanding concerns and resentments about the dollar and thus was bound to create a vehement reaction on the part of the Europeans. But perhaps an even more important factor underlying their reaction was the general expectation that large deficits in the US basic balance of payments would continue for at least the next year or two. It had been argued that the war-induced overheating of the US economy was mainly responsible for the increased deficits in 1966-69, and there were hopes that the end of the war might mean a return to a more normal level of economic activity and a favorable balance-of-payments position. In 1970, however, the United States was undergoing a recession, yet the basic payments deficit continued. With economic recovery, the outlook is for some acceleration in the growth of US imports, and consequently the trade balance may worsen. Nor is the outlook for the short-term capital account particularly encouraging to the Europeans. Depending of course on short-term economic trends on both sides of the Atlantic, substantial interest differentials favoring placement of short-term funds in Europe may continue. This means a continued although probably greatly reduced, inflow of dollars into the European central banks.

38. In this situation, European government officials and the European financial community found themselves agreeing that something had to be done, although the views as to what should be done differ widely between government officials and central bankers in the same country (most notably, in Germany), as well as from country to country. The European reaction to the dollar inflow has been greatly complicated by the economic ties within the EC and by various national rivalries, especially between France and Germany.

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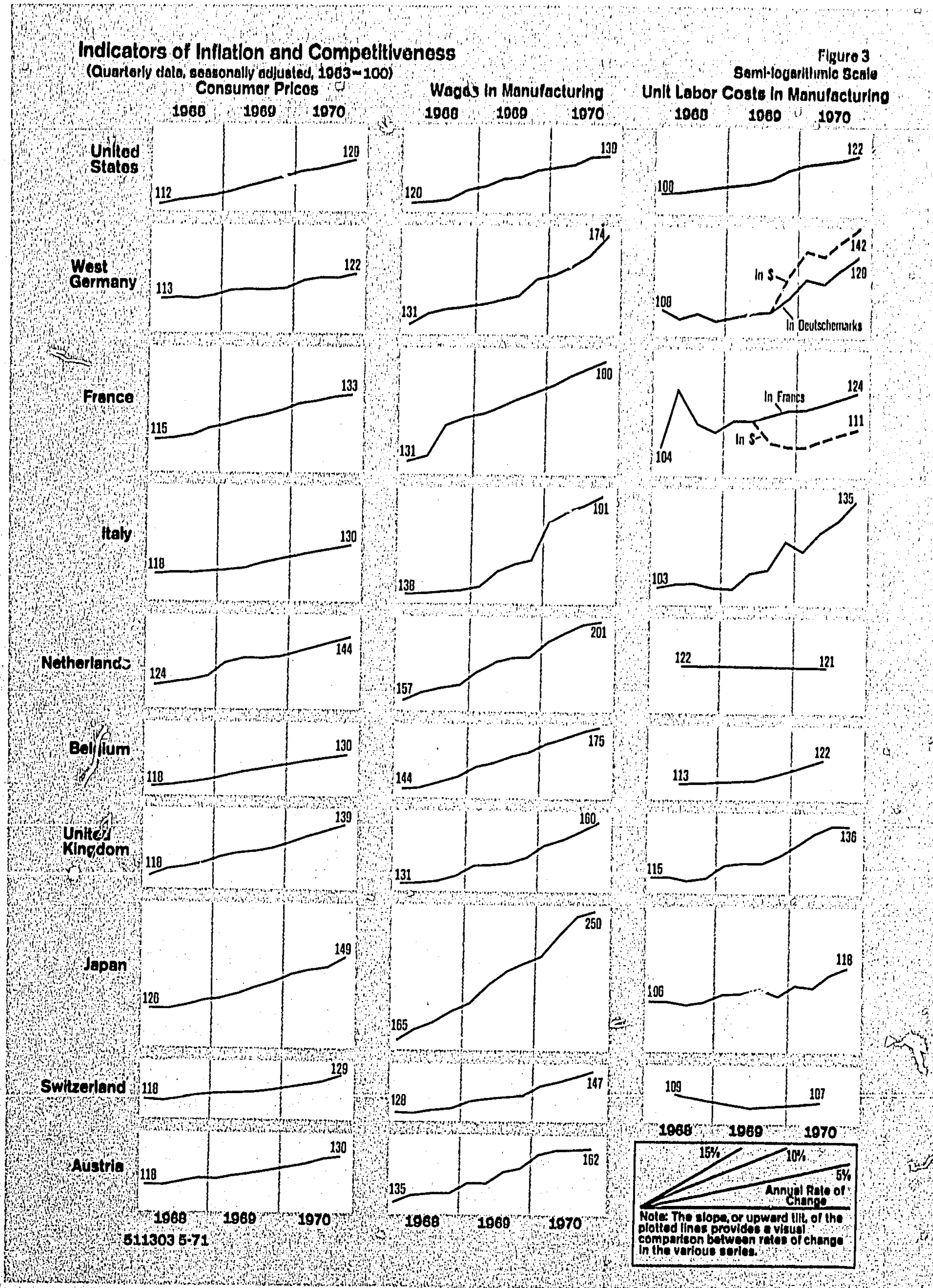
ECONOMIC FACTORS AFFECTING THE OUTCOME

68. The inability of the EC countries to reach agreement in substance at the 20-hour-long Council session on 8-9 May has roots in the quite different circumstances that face them in formulating economic policies at home and in the nature of their foreign trade and other external economic relations. The EC countries differ substantially with respect to their economic and social philosophies, goals, and traditional economic policies. At any given time, of course, they may be at different stages of the economic cycle and thus have differing short-term policy objectives.

69. The following sections examine indicators of inflation and competitiveness, foreign trade patterns, and the balances of payments for the EC countries and several other selected industrial countries. These indicators illustrate some of the economic factors underlying the divergences among the EC countries as to choice of an appropriate course of action. Brief country summaries, commenting on factors affecting the external position of each country, are included in the Appendix.

Inflation and Competitiveness

70. There are substantial differences not only in the degree of inflation experienced but also in the degree of official and public concern over inflation in the various countries. German concern with inflation may appear exaggerated to many: consumer prices in West Germany increased at an average annual rate of only 2.8% in 1968-70, the lowest of any of the countries shown in Figure 3. But this average masks a rapid acceleration of the inflation from 1.8% in 1968 to 2.7% and 3.9% in 1969 and 1970, respectively. During the first four months of 1971, consumer prices were rising at a seasonally adjusted annual rate of 8%. Although the 3.9% price rise in 1970 was low in comparison with those of most


Indicators of Inflation and Competitiveness
(Quarterly data, seasonally adjusted, 1963=100)
Figure 3
Semi-logarithmic Scale
Consumer Prices
Wages in Manufacturing
Unit Labor Costs in Manufacturing
1968
1969
1970
United States
West Germany
France
Italy
Netherlands
Belgium
United Kingdom
Japan
Switzerland
Austria
In $
In Deutschemarks
In Francs
Annual Rate of Change
15%
10%
5%
Note: The slope, or upward tilt, of the plotted lines provides a visual comparison between rates of change in the various series.
511303 5-71

other countries, to the Germans it was an omen of impending doom; they consider the present rate unbearable. Sensitized by the ravages of spectacular inflationary episodes in their economic history and convinced that price stability is essential to equity in an economic system, the Germans automatically rail at anyone or anything threatening to impose inflation on their economy.

71. The Dutch, who opted for a temporarily floating exchange rate along with the West Germans, are only slightly less preoccupied with inflation. Of late they have been much concerned with the rise of their consumer price index, which in 1968-70 increased at an average annual rate of 5.2% substantially above the 1960-67 average of 3.7%. The Swiss and Austrians share the view that inflation is highly undesirable; but their rates of inflation are among the lowest in Europe. However, they too, experienced relatively high inflation in 1970. In France, inflation has been more rapid than in most of the countries shown and is now causing widespread concern.

72. Increases in wage rates form a link between consumer price changes and unit labor costs. Higher consumer prices lead to more insistent wage demands; higher wages (in the absence of offsetting productivity changes) push up production costs and selling prices. These effects vary, from country to country, in part because of differences in the strength of final demand and the availability of unemployed resources. In many countries, however, there has been a growing tendency for labor to demand—and get—substantial wage increases even when economic conditions are slack. In all of the European countries shown in Figure 3, except for France, wage rates in manufacturing rose faster in 1970 than in 1969. Most spectacular were the rises experienced in Italy, Japan, and West Germany.

73. Export competitiveness, of course, depends not only on factor costs such as wages but also on the efficiency of the productive process. When labor costs are calculated with respect to output, the effects of rising wage rates may be offset by increases in productivity (or, sometimes, aggravated by decreases in productivity). The third panel in Figure 3 illustrates recent changes in wage costs per unit of output. Unit labor costs in West German manufacturing industry soared in 1970, fueled by rapidly rising wage costs not offset by increases in productivity. The increase in Italy was also very strong; that in France was moderate. These rising costs partly explain why exporters are opposing revaluations and favor devaluations of their home currencies. The preference of the French and Italian authorities for maintenance of existing parities to some extent reflects their desire to strengthen exports in the face of rising costs of production. However, German determination to float the mark under conditions in which it was certain to appreciate in value runs counter to this logic. The fact that West Germany took such action, fully aware that it would further erode the competitiveness of German exports (already under pressure from rising unit labor costs), is a measure of the strength of conviction underlying the decision to make domestic economic policies less subject to the vagaries of dollar flows under a regime of fixed, closely pegged exchange rates.

Foreign Trade Considerations

74. The pattern of the EC countries' foreign trade ties also entered into consideration in the recent decisions to float, revalue, or stand pat. A high proportion of these countries' foreign trade is intra-Community trade (see Table 1). Swiss

Table 1

Patterns of Foreign Trade, 1969 *

Exports, By Destination

Exporting Country or Area	Percent													
	United States	European Community						Switzer-land	Austria	United King-dom	Japan	Rest of World	Total	Total Exports (Billion US$)
		Total	Ger-many	France	Italy	Belgium-Luxem-bourg	Nether-lands							
United States	......	17.8	5.2	3.1	3.2	2.5	3.8	1.4	0.1	3.3	9.2	68.2	100.0	37.44
Total EC	7.9	.....	14.1	11.7	6.4	7.7	8.3	4.3	2.2	4.4	1.0	32.6	100.0	73.60
Germany	9.4	39.9	.....	13.3	8.2	8.2	10.2	5.7	4.3	4.0	1.4	33.2	100.0	29.08
France	5.5	47.8	20.6	....	10.4	10.9	3.9	4.5	0.6	4.1	0.8	38.7	100.0	14.88
Italy	10.9	42.6	19.7	14.3	.....	3.9	4.5	4.3	1.6	3.6	0.7	36.1	100.0	11.73
Belgium-Luxembourg	6.9	67.6	22.9	21.0	4.3	....	19.4	2.0	0.3	4.0	0.8	14.2	100.0	10.66
Netherlands	4.5	60.1	29.7	11.6	4.9	13.9	....	2.0	0.9	7.6	0.7	24.2	100.0	9.97
Switzerland	9.6	37.2	14.8	8.6	8.8	2.4	2.6	....	3.0	6.9	3.0	58.3	100.0	4.62
Austria	4.6	41.5	24.2	2.6	10.1	1.4	3.2	9.3	....	5.7	0.6	38.1	100.0	2.41
United Kingdom	12.3	19.9	5.1	4.1	2.7	4.0	4.0	2.4	1.0	......	1.8	62.6	100.0	14.39
Japan	31.4	6.2	2.5	0.8	0.9	0.5	1.2	0.7	0.1	2.2	......	59.4	100.0	15.99

Imports, By Source

Importing Country or Area	Percent													
	United States	European Community						Switzer-land	Austria	United King-dom	Japan	Rest of World	Total	Total Imports (Billion US$)
		Total	Ger-many	France	Italy	Belgium-Luxem-bourg	Nether-lands							
United States	......	16.0	7.2	2.3	3.3	1.9	1.3	1.3	0.3	3.9	13.6	62.9	100.0	36.05
Total EC	9.7	.....	15.1	9.6	6.7	8.8	7.8	2.3	1.3	4.7	1.2	32.4	100.0	73.38
Germany	10.5	43.6	.....	13.0	9.7	9.3	11.6	3.0	2.2	4.0	1.7	33.0	100.0	24.93
France	8.5	40.5	22.4	....	10.2	11.5	6.4	2.4	0.4	4.3	0.9	32.4	100.0	17.22
Italy	21.3	35.3	13.8	12.4	.....	3.6	4.9	2.4	1.9	3.6	0.9	41.1	100.0	12.43
Belgium-Luxembourg	7.7	57.4	23.2	15.9	4.0	....	14.3	1.3	0.3	7.0	1.0	23.3	100.0	9.99
Netherlands	9.7	56.7	26.7	7.8	4.5	17.7	....	1.3	0.7	3.7	0.9	23.0	100.0	10.99
Switzerland	8.5	58.1	29.2	12.1	9.7	3.5	3.6	....	4.2	3.1	1.8	19.3	100.0	3.27
Austria	3.0	56.3	41.3	3.6	6.6	1.7	3.3	7.6	....	6.6	0.8	25.5	100.0	2.83
United Kingdom	13.4	19.3	5.6	3.9	2.7	2.2	4.9	2.1	0.8	......	1.3	63.1	100.0	19.98
Japan	27.2	5.5	3.0	1.0	0.6	0.4	0.3	1.0	0.1	2.2	......	64.0	100.0	15.02

* This table is based on f.o.b. value of exports and c.i.f. value of imports (except for the United States, which reports imports on an f.o.b. basis).

and Austrian foreign trade is also heavily oriented toward the EC. The increases in exchange value for the mark and guilder have the immediate effect of making more expensive to the buyers some three-quarters of West Germany's intra-EC exports and half of the Netherlands intra-EC exports. France, Italy, and Belgium-Luxembourg, by maintaining the existing parities of their currencies, not only will tend to maintain their competitive positions outside the Common Market but also will chalk up trade gains in West Germany and the Netherlands, markets which account for roughly 60% of their intra-Community trade. Thus France and Italy had strong commercial motives for opposing the German plan that would have had Community exchange rates move upward together. West Germany, on the other hand, stands to lose competitiveness on sales to France, Italy, and Belgium-Luxembourg, as well as on sales to the rest of the world. The German policymakers, deliberately and in the face of strong objections from domestic commercial interests, decided to accept this—for a short period, at least—as a cost of regaining control over domestic credit conditions. The fact that the Netherlands sells nearly one-third of its exports to West Germany and obtains more than one-fourth of its imports there was an important consideration underlying the decision to float the guilder.

75. Once these decisions were taken, the situation of Switzerland called for action. Faced with rising exchange costs on a third of its imports, rapid domestic inflation (a new experience for the Swiss), and the likelihood of an increased inflow of dollars as a result of the *de facto* temporary revaluations of the mark and guilder, the Swiss decided to revalue their franc by 7.1%. Leaving aside the question of constitutionality of a floating rate for the Swiss franc, there was strong preference in Switzerland for outright revision of parity rather than use of a floating rate. This preference is largely attributable to Switzerland's important role as an intermediary and principal in international financial transactions, a role that is facilitated by the certainty of fixed exchange rates. The relatively large amount by which the Swiss franc was revalued reflected a concern to ensure that the increase in the cost of the franc would be sufficient to check decisively any further inflationary inflows of funds. With respect to Austria, the fact that West Germany is its most important trade partner weighed heavily in the decision to revalue the schilling. Maintaining the schilling at its old parity would have meant higher price tags on the 40% of total Austrian imports that come from West Germany.

External Economic Positions of Selected Countries

76. In 1970, wide swings occurred in the external payments of the countries shown in Table 2. The basic balance (combining the current account and long-term capital account) for each of the countries except Japan improved.* With the principal and notable exception of the United States, most of these countries registered substantial "improvement"—in an accounting sense—in their short-term capital positions. The swings from the 1969 basic balances and short-term

*No breakdown of capital account transactions for Switzerland is available.

Table 2

Balance of Payments of the United States and Selected Industrial Countries
(Official Settlements Basis)

Million US $

	United States		West Germany		Switzerland	
	1969	1970	1969	1970 [a]	1969	1970 [b]
Current and capital account	2,701	−10,682	−3,038	3,963	9	689
Current account	−883	638	1,804	730	444	−131
Capital account	3,586	−11,320	−4,842	3,213	−473	930
Long-term capital	−2,133	−2,929	−6,246	−1,233	N.A.	N.A.
Short-term capital	8,365	−7,117	1,110	3,809	N.A.	N.A.
Errors and omissions	−2,841	−1,274	294	2,639	N.A.	N.A.

	Netherlands		Belgium-Luxembourg		France	
	1969	1970 [a]	1969	1970 [b]	1969	1970 [a]
Current and capital account	−126	270	202	383	−1,224	1,362
Current account	−4	−481	84	744	−2,127	−812
Capital account	−122	731	114	−339	897	2,373
Long-term capital	−127	313	40	−142	325	373
Short-term capital	−35	157	−43	−314	673	1,300 [c]
Errors and omissions	40	31	126	97	−106	

	Italy		United Kingdom		Japan	
	1969	1970 [a]	1969	1970	1969	1970
Current and capital account	−704	373	1,743	3,089	800	1,008
Current account	2,372	813	1,049	1,514	2,119	2,023
Capital account	−3,076 [d]	−438 [d]	696	1,373	−1,319	−1,017
Long-term capital	−971	1,376	−22 [e]	−703 [e]	−133	−1,604
Short-term capital	−2,256	−931	−32	1,901	−1,305	302
Errors and omissions	−336 [f]	−832 [f]	770	377	145	106

[a] Estimated data.

[b] Preliminary data.

[c] Including errors and omissions.

[d] Capital account total includes banks; subtotal capital items are for non-banks only.

[e] Excluding current bonds held by official holders, but including estimates of private foreign owners.

[f] Including leads and lags.

capital balances (including errors and omissions) to the corresponding 1970 balances are shown in the following tabulation:

	Billion US$	
	Basic Balance	Short-Term Capital Balance
United States	+0.7	−14.1
West Germany	+4.0	+5.0
France	+1.8	+1.2
Italy	+2.8	+1.0
Netherlands	+0.2	+0.2
Belgium-Luxembourg	+0.5	−0.3
United Kingdom	−0.2	+1.0
Japan	−1.5	+1.8

Highlights of recent developments in the respective international economic position of the countries discussed in this memorandum are included in the Appendix.

Impact on the Gold Market

77. Subsequent to the closing of German, Swiss, and several other official foreign exchange markets in the first week of May, some speculators shifted their funds into gold. Demand for gold was generally very light, but because sellers were not forthcoming, the free-market price rose sharply in the days during and following the crisis. On Wednesday, 5 May, the day the foreign exchanges closed, the morning gold price in London was fixed at $39.66. By Friday afternoon 14 May, the free market price hit a 21-month peak of $41.20. Subsequently, the market softened somewhat. But uncertainty over the outcome of the German and Dutch "temporary" floating of the mark and guilder, together with the more basic concern over shrinkage of the US monetary gold stock, has kept the market off balance. Since the 14 May peak, the free-market gold price has fluctuated around $40. The upward movement of the free-market price of gold in the period following the crisis did not portend imminent collapse of the two-tier gold-market but rather is the sort of adjustment which the two-tier system was designed to accommodate.

The Foreign Exchange Record

78. In the days before the Bundesbank's 5 May closing of its exchange window, The European central banks were having to prop up the dollar to keep the exchange rate from slipping—or plunging—beyond the lower limit of the narrow band around parity considered legitimate under the fixed exchange rate system. After the withdrawal of official support by several countries (including West Germany, the Netherlands, and Switzerland—but not France), the dollar cost of the D-mark, guilder, and Swiss franc advanced sharply. When the exchange markets reopened on 10 May, the D-mark was floating at a rate about 3.5% above the nominal (old) parity. The guilder, also floating, was up about 2.7%. The Swiss franc, revalued by 7.1%, was selling slightly below its new par.

79. In the three weeks following the reopening of the exchanges, the speculators apparently continued to believe that the moment had not arrived for liquidation of their holdings, in effect that if they could outlast the Bundesbank, the mark would rise even higher. For about a week after 10 May the dollar/mark

rate fluctuated a little over 3% from nominal parity. Then for a few days the dollar cost of the mark shot up to about 4.5% above parity, on rumors that the Bundesbank would start selling dollars in large amounts at 5% above parity beginning Monday, 24 May. The 24th came and went, and the Bundesbank did not enter the market. The rate dropped sharply back to a level some 3.5% above parity. Then, in early June, the Bundesbank used several ploys to induce the market to buy back dollars. The effective appreciation of the D-mark rose to around 4.5% above parity, and a large volume of dollars began moving back into private holdings.

80. The Dutch guilder followed a similar pattern of fluctuation, rising sharply with the D-mark during 19-24 May, then falling to about 1.8% above its nominal parity at the end of May. The Swiss franc has fluctuated close to its new parity. It reacted sharply upward on 21 May to the rumors of Bundesbank dollar sales but then fell and remained slightly below parity through most of June. Throughout this period the French franc was generally stable.

81. The behaviour of exchange rates during May—when speculative activity had been neutralized for the moment and the Bundesbank had not started pumping dollars back into the market—suggests that existing parities for the stronger foreign currencies, except perhaps the Japanese yen, are not seriously out of line with each other. Four members of the West German Council of Economic Experts reportedly recommended revaluation of the D-mark by about 3% at the end of the floating period; the fifth believed a return to the existing parity would be appropriate. The majority feel that a return to the old parity would bring danger of renewed domestic inflationary pressures and excessive balance-of-payments surplus. Should such pressures recur, the Council of Experts recommends consideration of further small revaluations to maintain pressure on domestic wages and prices. If the Germans revalue, say by 3%, the Dutch might well find a revaluation of around 2% compatible with domestic economic objectives, their trade relation with West Germany, and recent exchange market trends.

OUTLOOK

We believed ourselves to be in agreement with the majority of our partners. I am not criticizing the Federal Republic of Germany, which has its own problems, although it sometimes tends to create problems for itself. The recent Brussels decisions concerning the monetary crisis poorly camouflaged a solution which was not "communitarian" but rather "anticommunitarian." We and our partners believed it better to give our blessing to these decisions, but we somehow had the impression of signing a pact with the devil. I only hope, but without much conviction, that we may return to a normal situation by 1 July.

We have to start forward again. Certainly nothing will be basically resolved, because there is still the dollar. It is not a question of declaring war on the dollar, for this would provoke a crisis in the entire Western world. But for Europe to remain "European," it must not remain eternally linked to the standard of a currency which steadily loses its value because of domestic problems peculiar to the United States.

One cannot forever set his watch by a clock which loses time. We are not going to settle this problem in the succeeding months. But Europe should acquire a monetary personality which will permit it to be itself and to enter into a constructive dialogue with the United States. However, my wish for this is stronger than the probability of such a discussion in the coming few months.

President Pompidou
(at a press conference in the French Embassy, Brussels, 26 May 1971)

82. Some of the factors which precipitated the present crisis have been present in previous dislocations in the postwar international monetary system. But, this time, new variations on old themes combined with new considerations to produce a qualitatively different result. Instead of leading to another concerted attempt to patch up the mechanism and return to the *status quo ante*, the conjunctiare of economic and political forces this time led to a break away from the postwar pattern of the United States leading and Western Europe following in monetary crisis management. Although dollars comprise a major share of their international reserves, the West European countries are no longer willing to accede to the proposition that, therefore, the United States' interests are their interests. Clearly, many of the old ties remain. Moreover, European monetary authorities holding billions of dollars in claims against the United States, have no intention of destroying the value of these international reserve assets. Cooperative borrowing and lending between governments will continue to cushion the impact of large monetary flows. But there will be a new wariness and guardedness in European monetary relationships with the United States.

83. The Europeans will set an increasingly independent course when monetary cooperation with the United States conflicts with their domestic economic policies. Ironically, the disagreement within the EC has retarded Community progress toward a common exchange-rate policy and in that sense has prolonged their dependence on the dollar. Nevertheless, the EC countries probably will approach future monetary crises with a new attitude—feeling able to act other than in concert with the dollar and to apply ad hoc measures suited to their immediate needs, the niceties of the IMF agreement notwithstanding. In time they may be able to achieve close coordination of economic policies and exchange rates, thereby gaining the ability to act in concert against the dollar. Although a return to present parities (for example, 27.3224 US cents per D-mark) is possible at the end of the period of floating, this will not be an unqualified return to Bretton Woods.

84. These new attitudes do not spell international monetary anarchy. The present system has already been stretched and twisted without collapsing. Moreover, the steps taken in the current crisis have focused attention on flaws in the existing mechanism, and it is likely that the West Europeans will join in a search for modifications of the system within the IMF framework of cooperation. Governor Carli of the Bank of Italy stated in the wake of the crisis that the present international monetary system is no longer compatible with stable economic growth, that the system must be changed, and that the creation of SDRs was a step in this direction. In Germany, former Chancellor Erhard called for reform of the Bretton Woods system, calling it a system based on a dollar shortage that no longer exists. Economics Minister Schiller agreed, declaring that recent German government actions were designed to open a breach for reforming the Bretton Woods system in the direction of more flexibility. It is hoped that a system will evolve that can accommodate international flows of goods, services, and capital in response to market forces and, at the same time, permit progress toward domestic economic goals without interruption by recurrent international monetary crises.

85. Given US determination not to devalue the dollar (that is, determination not to raise the Treasury's buying price for gold) and not to endanger US domestic reflation by measures such as higher interest rates to curb the flow

of dollars to Europe, the ball was in the European court. The Europeans consider that they have the right to implement domestic economic policies without being subjected to the disruptive effects of international monetary disturbances such as the dollar inflow. Having concluded that the crisis was not the result of fundamental disequilibrium, the Europeans' policy choice, at least within broad limits, was between floating exchange rates and stringent exchange controls. Although the concept of a floating rate traditionally has been bitterly opposed by commercial and banking interests, in the view of many economists it is an effective approach to exchange rate adjustment and, ultimately, one less damaging than the alternative proposed by France.

86. In discussions of the need to counteract disequilibrating short-term capital flows, some Community officials have shown considerable interest in a dual exchange market on the Belgian pattern. The mechanics and implications of this system are being subject to searching inquiry by EC central banks, including the Bundesbank. Under such a system, exchange for settlement of trade and other current account transactions would be available at the official rate (that is, within a narrow band around parity); payment for capital transactions would be channeled through a free market where the exchange rate would automatically adjust to changing conditions of demand and supply of the currencies.

87. Another aspect of international monetary activity—the Eurodollar market—is also being examined minutely and probably will be subjected to substantially increased regulation. Governor Carli, for example, has stated that at the heart of the current international money problem is the US balance of payments and the Eurodollar market. Unless controls are soon placed on the growth of this market, according to Governor Carli, the current multiplier could be greatly increased in the near future. EC Commission Vice President Barre sees inadequate control of the Eurodollar market as a factor which—together with dollar deficits, internal inflation in the EC, and speculation—led to the recent crisis. Many observers, however, mention the positive contribution of Eurodollars. Prime Minister Werner of Luxembourg, for example, has stated that he would not like to see the Eurodollar and Eurobond markets disappear or be severely curtailed by excessive capital restrictions; Europeans have benefited from this international capital market both in relationship to their own growth and to their progress in integrating their economies.

88. It is difficult to assess the implications of this crisis for EC unity. The signals are mixed and many aspects of Community activity are affected in different ways and in varying degree. In a broad sense, EC unity has been set back by the strongly assertive manner in which the Germans forced the floating of the mark. Governor Carli's reaction to the political implications of the German action is interesting. Stating that Italy's decision to hold to the existing parity was not a question of taking sides between the United States and Europe, he added the question was whether "to get into the boat with one rather than two elephants." With respect to European unity on the issue of of pulling together in the direction of international monetary reform, Schiller holds that as a result of the Brussels compromise, Germany will now have more allies in seeking to bring about more flexibility in the system. This view appears to be supported by Italian Treasury Minister Ferrari Aggradi's statement that recent developments should give impetus to efforts to improve the

working of the system. This may be so, but it is probably safe to say that on a political level the Five do not appreciate the service Germany claims to have done them in providing the initial push.

89. The EC's planned movement into the first stage of economic and monetary union has been seriously impaired. This, however, may turn out to be an ultimate advantage to the Community. In a sense the February 1971 decision to proceed into the first stage of union by narrowing the band for EC currencies was a bit like children playing house: all would be fine in the absence of a crisis. But a crisis occurred and focussed attention strongly on the diversity—as well as the similarities—of economic interest among the EC countries and on the need for more effective coordination of economic goals and policies before common monetary action can be feasible and durable under both favorable and unfavorable conditions. When the floating ends and the French return to discussions of monetary union, there will undoubtedly be an effort to establish a more sensible relationship between horse and cart. Being optimistic by nature (according to his own statement), Prime Minister Werner still remains optimistic about economic and monetary union despite recent events. He likened the situation to the "Echternach Passion Dance" where one takes two steps backward before taking three steps forward.

90. With respect to other aspects of EC activity such as the CAP, cooperation appears to be continuing. The EC Agricultural Ministers reached a difficult agreement on 12 May to permit West Germany and the Netherlands to use compensatory import taxes and export subsidies to offset the impact of floating exchange rates on German and Dutch farm incomes whenever the mark or guilder may rise more than 2.5% above parity. Also, substantial progress in the enlargement negotiations appears to have occurred at the 11-13 May sessions with the United Kingdom. Possibly the shadow of growing German power cast in the 8-9 May EC Council meeting influenced the French to be somewhat more receptive to compromises with the British, feeling that having the United Kingdom would tend to dilute German influence.

91. The willingness of the United States to cooperate in moving surplus dollars back from Europe by means of special financing arrangements has been noted favorably in official circles and in the European press. Bundesbank President Klasen, for example, stated publicly that negotiations with the United States are necessary and that the United States is "quite willing to help."

APPENDIX

Current Balance-of-Payments Trends in Selected Countries

UNITED STATES

The record $10.7 billion (excluding SDRs) official balance-of-payments deficit in 1970 largely reflected short-term capital outflows which, because of relative easing of US monetary conditions, more than offset an increased, although still small, merchandise trade surplus and a continued healthy surplus in investment income. On balance, there was little change in other capital and in current flows.

The trade surplus rose in response to cyclical developments that slowed import growth, particularly in the first half of the year. Slackened US demand was mirrored in only a 3.6% rise in import volume, while buoyant foreign demand contributed to an 8.4% improvement in export volume. Most other current transactions continued to show little change. Investment income and non-military service inflows as well as military transactions outflows remained close to 1969 levels. Only remittance and pension outlays registered a notable rise.

Net long-term capital outflows rose somewhat as net direct investment expenditures abroad—particularly in the first half of 1970—picked up, probably as a result of the sharp rise in plant and equipment spending by foreign affiliates of US corporations. Moreover, the net inflow of other private long-term capital items was 44% of the 1969 level. In particular, demand for US securities was slack in the first half of 1970 and net disinvestment occurred in US stocks; substantial recovery occurred in the last two quarters of the year, in response to the recovery of the stock market.

Prior to the recent European currency adjustments, the net balance on long-term capital and current accounts in 1971 was expected to remain at 1970 levels. Trends in the second half of 1970 were anticipated to carry into this year, that is, a smaller trade surplus as US import demand picked up and larger inflows of portfolio capital as domestic market conditions and confidence improved.

The recent exchange rate developments could have a favorable, although small, impact on the trade balance. Some of the anticipated slack in internal demand in the four countries which made currency adjustments could be offset by the improved competitive price position of US products in these markets. US exports to third country markets where they face competition from West Germany and the Netherlands may also benefit. Moreover, investment income inflows from US affiliates in the Netherlands and Germany should be increased to the extent that higher exchange rates prevail.

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FRANCE

Although not involved to any great extent in the "hot money" flows that precipitated the foreign exchange crisis, France played an important role in the political consultations shaping the outcome. It blocked the German proposals in the EC Council to float all Community currencies and holds to the view that "devaluation of the dollar" is necessary. It therefore strongly disapproves of any West European parity adjustments, but, if such adjustments are inevitable, France wants the result to include some devaluation of the franc in terms of the mark. Its recommendations for raising the price of gold and for increasing general exchange controls have been heard many times. Some French francs have entered into recent currency speculation, and some dollars have spilled over into the French exchange markets; however, as concerns the massive, disequilibrating money flows in this crisis, France was essentially an interested bystander. France's complex exchange control apparatus, combined with the relative unattractiveness of the franc, insulated the financial system from major speculative short-term capital flows.

Nevertheless, private short-term capital inflows were a major factor in France's $1.6 billion official balance-of-payments surplus in 1970 and weigh importantly in a projected surplus of well over $1 billion in 1971. Rather than being "new" money, much of this short-term capital inflow reflects a relatively steady return of the billions of francs which poured out of France prior to the devaluation of the franc and revaluation of the D-mark in late 1969.

In addition to the large 1970 short-term capital surplus, the basic balance (current account plus long-term capital) also showed marked improvement, the deficit decreasing from $1.8 billion in 1969 to only $200 million in 1970. After two years of deficit, the current account moved into near equilibrium in the first half of 1970, as a result of a sharp increase in exports and a stagnation of imports. However, export expansion slowed in the second half of the year (in response to slower economic growth in some of France's major markets, rather than to any deterioration in its competitive position), imports resumed a normal rate of increase, and the current account moved back into substantial deficit. The traditional surplus on long-term capital only partly offset this deficit. An inflow of some $1.8 billion in short-term capital in 1970 combined with the small basic deficit to produce an overall surplus of $1.6 billion. Projections for 1971 indicate little change in the basic deficit, but with some slowing of short-term capital inflow the overall surplus is expected to be closer to $1 billion.

Because of its relatively healthy balance of payments and its ability to regulate most short-term capital flows, the French Government apparently feels capable of pursuing more independent—and restrictive—domestic monetary policies than its neighbors. Inflation (currently running at an annual rate of around 6%) is generally considered as the primary economic problem in France. The recent upward exchange rate adjustments in West Germany, Austria, Switzerland, and the Netherlands (together accounting for about one-third of French exports and imports) will increase the pressure on prices by raising the cost of imports. In addition, the improved competitive position of French exports resulting from the new exchange relationships may put some strains on the capacity of firms producing both for export and domestic consumption. At the same time, unemployment—which increased sharply and steadily in 1970—may be reduced by the expected increase in demand for French exports, as well as by some import substitution.

ITALY

Italy's official settlements balance-of-payments improved sharply in 1970, moving from a deficit of $704 million to a surplus of about $375 million. The improvement was largely due to a sharp reduction in short-term capital outflows, reflecting restrictive monetary policies and increased confidence in the political situation. The basic balance also improved sharply, from a $1.4 billion surplus in 1969 to a $2.2 billion surplus in 1970, with deterioration in the current account more than offset by rising long-term capital inflows reflecting extensive borrowing abroad by state enterprises and financial institutions. The balance-of-payments improvement continued in early 1971 and the lira showed considerable strength. But Italy was shielded from more than marginal dollar inflows during the recent monetary crisis by the lira's traditional reputation as a less stable currency, as well as by some continuing domestic political and social uncertainties, and the ability of the central bank to apply strict controls to limit speculation.

The current account surplus weakened in 1970, dropping to $800 million from a $2.4 billion the previous year under the impact of domestic strikes and large wage increases. The strikes produced supply bottlenecks, inhibiting export growth and encouraging imports, and deterred the growth of tourism. The wage increases resulted in increasing imports and Italian tourist expenditures abroad. Although the strikes and wage increases led to a sharp upturn in export prices, Italy retained its competitive export price position because of the even larger price increases abroad.

Net long-term capital inflows amounted to $1.4 billion in 1970 compared with a net outflow of close to $1 billion in 1969. Net private and official loans accounted for most of the improvement and, along with a direct investment inflow, offset a deficit on portfolio transactions. The illegal exportation of banknotes, which accounts for a large part of the short-term capital outflow dropped from a record $2.3 billion in 1969 to just under $1 billion.

Upward movement of the mark, guilder, Swiss franc, and schilling exchange rates will probably have only marginal effects on the Italian capital account this year, but should contribute to a stronger current account performance. In particular the value of emigrant and worker remittances from Germany, the Netherlands, Switzerland, and Austria (39% of the total) should increase. Moreover, since close to half of the foreign visitors to Italy come from these countries, larger rises in tourist expenditures can be expected. The net impact on the trade account is less clear, but should also be favorable despite some initial worsening in the terms of trade (the four countries supply more than one-fourth of Italy's imports). Domestic demand has shown signs of weakening in early 1971, auguring a slowdown in import growth in any case. Moreover, the competitive position of Italian products in these markets (which absorb 30% of Italian exports) will improve. If domestic strike activity declines as anticipated, Italy will have available the capacity to meet stronger demand from these countries (in particular Germany and the Netherlands, where demand for Italian products is highly sensitive to changes in price). In short, the currency adjustments should improve the current account surplus and add a timely stimulus to domestic growth through stronger foreign demand.

NETHERLANDS

The appearance of a $32 million basic balance surplus in 1970 (compared with a $131 million deficit in 1969) conceals the fundamentally unhealthy character of the Netherlands' balance of payments. The 1970 basic balance surplus resulted from a hefty inflow of long-term capital which offset a serious current account deterioration.

The current account slipped from near equilibrium in 1969 to a $481 million deficit in 1970. This deterioration was due principally to a negative trade balance of $640 million, resulting from a rise of 22.7% in imports but only 18.7% in exports. The trend is continuing in 1971. For the first quarter of 1971 the trade deficit stood at $276 million (as compared with $193 million in 1970).

Foreign exchange reserves increased significantly in 1970 as a result of the sizable capital inflows. Accompanying the heavy inflow of long-term capital in 1970 was a $218 million surplus in the short-term capital account that reflected very heavy inflow during the second half of the year.

Despite its current account deficit, the Netherlands decided to float the guilder, following in the footsteps of its chief trading partner, West Germany. Underlying the action was the need to prevent further inflow of speculative capital to help combat inflationary developments at home. With inflation at an annual rate of about 6% and wages increasing at about a 10% rate during the past two years and no let up seen for 1971, the Netherlands felt compelled to check decisively the inflow of capital which had already stymied its restrictive monetary policy.

The inaction by most of the Netherlands' trading partners, particularly Belgium—with which the Netherlands had a $600 million trade deficit in 1970 (customs basis)—promises to have an adverse impact on the Netherlands' competitive position. If final resolution of this crisis involves a return to pegged rates with a rise in the parity of the mark, it is likely that the guilder will be revalued by a lower percentage.

BELGIUM-LUXEMBOURG

The Belgium-Luxembourg Economic Union (BLEU) basic balance surplus jumped from $124 million in 1969 to $602 million in 1970. A lower rate of inflation in BLEU than in most other EC countries contributed to the current account surplus increasing from $84 million in 1969 to $744 million in 1970. Over the same period the change on long-term capital account was from an inflow of $40 million to an outflow of $142 million. This was largely due to a sharp decrease in governmental borrowing abroad. The long-term private capital outflow continued at about the same level as in 1969. The short-term capital balance reversed from a $78 million inflow in 1969 to a $217 million outflow in 1970, primarily in response to higher interest rates prevailing in neighboring countries.

The current account is expected to continue in strong surplus in 1971. Because of Belgium's relatively slow inflation, consumer demand for imports is likely to increase at a less rapid rate than in either 1969 or 1970. Exports to the other EC countries are expected to account for more than 70% of total BLEU exports in 1971. As BLEU has decided to maintain the existing value of its currency in relation to the dollar for current account transactions, it will gain a competitive price advantage in West German and Dutch markets. But because productive capacity is almost fully utilized, the gain realized will have to come from new productive capacity.

Enhancing the stability of the BLEU external transactions is the two-tier exchange market. All current account transactions are handled on the official market, and all capital flows are channeled through the free market, where the

Belgian franc finds its own level against other currencies. The immediate effect of modification of the two-tier system is to insulate the rate applicable to commercial trade transactions from the disturbing influence of currency speculation.

SWITZERLAND

The Swiss balance of payments and the country's overall economic situation both have changed drastically since 1969, largely as a result of foreign influences on the very open Swiss economy. The current account of the balance of payments shifted from a substantial surplus in 1969 to a small deficit in 1970. At the same time, the capital account turned around, from a large deficit in 1969 to an even larger surplus in 1970. The latter change resulted basically from huge short-term capital inflows in the last half of the year as Swiss interest rates rose.

Since 1969 the Swiss economy, while remaining at full employment, has been experiencing a slowdown in the real growth of output and a sharp acceleration in the rate of inflation. Supply limitations, in particular a very small increase in the labor force because of limitations on immigration, have been the principal constraints; demand has remained strong. Accelerating price inflation resulted—initially, from strong foreign demand and rising import prices, and, later, also from substantial wage gains as well as capital inflows. Traditional fiscal and monetary measures could not be applied effectively enough to stem the growing price rises, and revaluation of the Swiss franc was advocated by many as a means of countering the inflation.

While formerly advocated as an anti-inflationary measure, the 7.1% revaluation of the Swiss franc came as a direct result of the foreign exchange crisis and, in particular, the German decision to float the mark. The Swiss felt that failure to follow the German action immediately, either by revaluing or by floating the franc, would lead to massive capital inflows in anticipation of an eventual revaluation of the franc. The government chose to revalue because the constitutional authority for a floating franc was not clear and—perhaps a more important reason—because it believed a floating franc to be incomptible with Switzerland's role as an international financial center.

The Swiss revaluation will probably be effective in preventing large speculative capital inflows and it should contribute to the reduction of inflationary pressures. The revaluation will undoubtedly cause trouble for Swiss exports; and thus will probably increase the previously expected balance of trade deficit, but the effects of the revaluation on trade may prove to be relatively small. Before revaluation, the dollar price on the Swiss franc was close to the upper limit—nearly 2% above parity. The market price of the franc since revaluation has remained close to the new parity, so that the actual rise above pre-revaluation levels has been only about 5%. Moreover, imported inputs will become somewhat cheaper, and Swiss wage gains may be held down somewhat as a result of reduced prices for imported consumer goods. In any event, Switzerland's international reserves are probably high enough to enable Switzerland to withstand a substantial deterioration in the balance of payments with little difficulty.

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